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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

No. 886

UNITED BLOCK COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

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The United Block Company, Inc., a New York State manufacturing corporation (hereinafter referred to as the taxpayer), prays that a writ of certiorari issue to review the decree of the United States Circuit Court of Appeals for the Second Circuit, entered in the above cause on December 17th, 1941, which affirmed a certain order of the United States Board of Tax Appeals, entered the 27th day of November, 1940, determining a deficiency of $29,841.80 in petitioner's income tax for the year ending September 30th, 1936 under Section 102, Revenue Act of 1934.

Opinions Below.

The opinion of the Board of Tax Appeals is reported in 42 B. T. A., page 1481 Mem. The opinion of the United States Circuit Court of Appeals has not yet been reported, but is found in the Record at pages 120, *et seq.* The decision of the Board is to be found at page 15.

Jurisdiction.

The decree of the Circuit Court of Appeals was entered December 17th, 1941 (R. 123). The jurisdiction of this Court is respectfully invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13th, 1925.

Questions Presented.

1. May the penalty prescribed by Section 102, Revenue Act of 1934 be imposed upon the accumulation of gains and profits made prior to the taxable year?

2. May the petitioner, a manufacturing corporation, be penalized under Section 102, Revenue Act of 1934, for permitting its gains and profits to accumulate in the taxable year when its actual net worth at the end of the taxable year was less than it was at the close of the preceding taxable year?

3. Can the taxpayer be penalized under Section 102 of the Revenue Act of 1934 for relying upon the direction of the officials of the Bureau of Internal Revenue as to the year in which it should charge off a bad debt?

4. Can the purpose condemned by this section be predicated upon the form of the accumulation, rather than on the fact of it?

5. Can the failure of the taxpayer to charge off a bad debt in the taxable year, or, for that matter, to charge it off at all, prevent it from showing later that it actually existed, was known, and exceeded the net income for the taxable year?

6. Can the imposition of the penalty provided by this section be justified upon the assumption that in some later year the taxpayer would have permitted gains and profits to accumulate for the condemned purpose?

Statute Involved.

Section 102 of the Revenue Act of 1934 reads as follows:

"102. Surtax on Corporations Improperly Accumulating Surplus.

"(a) Imposition of Tax. There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation (other than a person* holding company as defined in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting gains and profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

"(1) 25 per centum of the amount of the adjusted net income not in excess of $100,000, plus

* So in U. S. C. A. probably should be "personal." Sec. 351.

"(2) 35 per centum of the amount of the adjusted net income in excess of $100,000.

"(b) *Prima Facie* Evidence. The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to avoid surtax."

Statement of Facts.

Petitioner is a manufacturing corporation, incorporated in the State of New York, and formed in 1917 by the merger of three corporations. Its business is the manufacture of last blocks and ten pin blocks. These are made out of hard maple logs. From the raw log to the finished product takes a year and one-half to two years, two years and more before payment is received. The interval is spent in drying out the logs and blocks. The process is described in the testimony of O'Dell (R. pp. 38-43). This was not disputed, and was accepted as true by the Board, the hearing member shutting off the witness Murphy when he started to corroborate it (fol. 233).

The result was that petitioner was obliged always to carry large inventories of its product, from the raw to the finished state. In view of the scarcity of maple timber, the only usable kind, it was also obliged to buy timber tracts, large and small, when they came into the market; the early source of this supply, logs obtained from farmers, having become scarce. During its early years, it operated largely on borrowed money (R. Exhibit 8, p. 99). The management was always conservative, and had to keep a considerable sum invested in timber tracts. The supply grew scarcer, and competition developed from furniture manufacturers, who purchased hard maple for veneers.

Petitioner first seriously felt the effects of the depression in 1932, when its sales dropped to $445,000 as against $799,000 the year before (R. 99). The next year they dropped to $406,000, an all time low. Thereafter they increased to

1934	$ 492,000
1935	619,000
1936	784,000
1937	1,161,000

The taxpayer had made some investments from time to time, mainly in connection with its business. These, however, were small, growing from $12,150.00 in 1919 to $53,000 in 1933. The depression, however, and its consequent lack of sales, released a quantity of cash. This, in the belief that business would come back and require it, the directors invested in marketable securities, as offering a larger return than bank deposits and being readily convertible into cash as required (R. 53, 54). The tables are given in Exhibit 4 (pp. 110, 111, 112). This account amounted to $322,360.17 at the end of 1936, the taxable year; of which $83,825.01 represented a profit on the sale of securities previously acquired.

In 1932, to meet the falling off of the last block business, petitioner engaged in the manufacture of ten pin blocks. This business increased from $80,000 in 1932 to $553,000 in 1937 (Ex. 10, p. 101).

In 1936, the taxable year, petitioner's income was, as figures by the respondent, $124,207, and its adjusted net income was $113,833.71 (R. p. 12), of which, as shown, over $83,000 accrued through the sale of securities.

As against this, it suffered a loss of $150,000 in the taxable year in a bad account. This it attempted to charge off in that year, but was advised by the officials of the Internal Revenue Department that this could not be done (R. 47, 48). The "identifiable event" which made a charge-off proper in that year was the visit of petitioner's attorney to the debtor's plant in Brooklyn, at petitioner's request, and his report back that the account was worthless (R. 48). It was charged off *in toto* the next year.

As pointed out in the opinion below (R. 120), petitioner corporation had been formed in 1917 by the merger of three independent companies. A gentlemen's agreement was made at the time that the stock of Schelter, Harris and Belcher would be retired as fast as the new corporation could earn it out. This was done prior to 1932 as to Harris and the Schelters, and all the outstanding preferred stock was also retired. In 1934 and 1935, $52,500 of stock was retired. Belcher's stock, however, had never been retired. He died prior to 1936, and his estate owned 338 shares out of a total of 1729, or 19.9% plus. Its book value was upwards of $250,000 (Board's findings; R. 17, 18). His executor was clamoring for redemption, so as to be able to settle the estate. This constituted no legal obligation of the petitioner corporation, but good faith and common honesty required that it be done. The directors were contemplating doing this in the taxable year, provided funds were available (R. 50).

In the taxable year, petitioner's directors were contemplating the purchase of a tract of hard maple timber for $400,000 (Board's findings, R. 18). In the same year, O'Dell and Murphy were considering a severance of the business into two units, with separate corporate ownership; Murphy

wishing to acquire the Ellicottville plant, where he had other interests (Board's findings, R. 19). Murphy was seventy-five (R. 77, 81). This would call for a considerable sum in owelty, the amount being undetermined, since nobody knew what it would be.

None of these matters contemplated became *a fait accompli* in the taxable year. Not all could have been done, for the Belcher stock at $250,000, plus the timber at $400,000, would take more than all the cash and securities on hand. In 1937, there was a deficit in income, which made these expenditures out of the question. In 1938, the business was divided, the timber purchased (at a saving of $150,000), and the Belcher stock purchased by Murphy for $125,000 (R. 80).

The Board, after finding the facts substantially as above, held that "the accumulation was far more than necessary to provide for any probable increase in the ten pin business, for the possible redemption of the Belcher stock, for the write-off of the Daetsch and Woodward indebtedness, and for any possible incidental effect of the proposed segregation of the Hickey and Murphy plant. No large tracts of timber were bought" (R. 20).

On this state of facts, the Board determined that "petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of the business" (R. 19).

There is no direct finding anywhere that this accumulation was for the condemned purpose.

The taxpayer petitioned for a review in the Circuit Court of Appeals for the Second Circuit, where the determination

of the Board was affirmed, but not for the reasons contained in the Board's opinion.

Specifications of Errors to be Urged.

The learned Court below erred:

1. In holding, in effect, that the additional tax fixed by Section 102 of the Revenue Act of 1934 could be imposed upon the gains and profits accumulated prior to the taxable year.

2. In holding that there was substantial evidence to sustain the findings of the Board of Tax Appeals.

3. In holding that the imposition of the penalty provided by Section 102 of the Revenue Act of 1934 could be justified upon the assumption that in a later year the taxpayer might or would have permitted its gains and profits to accumulate for the condemned purpose.

4. In holding that the failure of the petitioner to charge off a bad debt in the taxable year prevented it from showing, as a matter of right, that it existed in the taxable year and exceeded the net income for that year.

5. In determining that the liability of the petitioner to the penalty provided by Section 102 of the Revenue Act of 1934 could be predicated upon the form of the accumulation, rather than on its amount.

6. In affirming the order of the Board of Tax Appeals.

Reasons for Granting the Writ.

1. The tax, or penalty, in this case was imposed, ostensibly on the income for the taxable year. At least that was the measure of it (R. 12). But it was in fact imposed upon the surplus of gains and profits accumulated in prior years, and was sustained by the Court below on that theory. For in the taxable year, the income as figured by the Court was $124,207 (R. 123) and as figured by the Board $115,166.21 (R. 17). In the same year, petitioner sustained a loss of $150,000 on a bad account. This was not charged off until the following year. Whether the petitioner is right in its contention that it was entitled to charge this off in 1936, but refrained from doing so by reason of the directions of the officials of the Revenue Department, or the Court was right in its statement that such directions are to be accepted at the taxpayer's peril, is not here material. The fact is that there can be no gains and profits in the taxable year, when the loss sustained in that year exceeds such gains and profits, whether it is correctly charged off or not, or whether it is never charged off at all.

Conceding this, the Board held that the *accumulation* was far more than necessary for "the write-off of the Daetsch and Woodward indebtedness * * *. The $150,000 Daetsch and Woodward account was comparatively small *and its complete write-off would still leave ample surplus for a dividend*" (R. 20, italics supplied).

It is plain here that the Board uses the word "accumulation" as applied solely to gains and profits accumulated in prior years, for the deduction of a loss $150,000 from an income of $124,000 would show a loss, rather than a gain or profit, for the taxable year.

The Court below sustained the Board on a different theory. It says (R. 121), "As will appear, we think this test valueless, but, even though we accept it, it will not serve, for the ratio of sales to capital for the year 1935-36 was 1 to 1.70, *though we deduct, as the taxpayer wishes, an account receivable of $150,000,* which it says that it had determined to be worthless during the year" (Italics ours).

Deduct it from what? Necessarily, from the income of $124,000, since that is the only item from which the deduction can legally be made. The accumulations of capital and surplus of prior years are beyond respondent's reach. There is no income tax on capital. But, if so deducted, there is no gain or profit in the taxable year, and where there is no gain or profit, there can be no accumulation *in the taxable year.*

Thus, in effect, if not in words, both the Board and the Court impose the tax upon prior accumulations. The Board does so in words, saying that the write-off of $150,000 would leave ample surplus for a dividend (which, in that event, would have to be paid out of prior accumulations, there being nothing else and no other source); the Court does so in substance, for its determination of "an accumulation beyond the reasonable needs of the business" is computed on the theory that, after deducting the $150,000, there are no gains or profits for the taxable year at all. These holdings are in direct conflict with *Helvering v. National Grocery Company,* 304 U. S. 282, where the Court makes it plain that the tax is imposed upon the income of the taxpayer *for the taxable year,* solely in instances where the corporation is availed of, *within the taxable year,* through the medium of permitting its gains and profits *of that year* to accumulate.

And, prior to this case, the Board has consistently so held.

Helvering v. Corporate Investment Co., 40 B. T. A. 1156, 1171.

2. This seems to be the first reported case where this tax has been imposed upon a manufacturing corporation. Since these corporations constitute the bulk of heavy taxpayers, it is of consequence that the important questions of law involved herein should be settled by this Court.

It is true that in *J. M. Perry Co. v. Commissioner*, 120 F. (2d) 123 (C. C. A. 9), a similar tax or penalty was imposed upon a warehousing corporation. The taxpayer there claimed that the retention of its surplus was for repairs and betterments. It appeared, however, that it invested part of this in real estate and started the construction of dwellings thereon, that it lent large sums to persons having no connection with the business, bought a business building for its chief stockholder, and made a substantial loan to him. These enterprises seemed to the Court inconsistent with its claim that it retained a surplus for betterments *because the surplus was not in available cash or quick assets.*

This case, so far as it goes, is in direct conflict with the ruling in the case at bar; wherein the Court says that the test is the ratio of quick assets to sales. Neither theory is believed to be entirely sound. The statute makes no discrimination between the different forms an accumulation may take. To predicate bad faith upon the retention of part of petitioner's surplus, including income, in ready cash, or marketable securities (quick assets), where only such could be used to purchase timber or retire stock, would seem to ignore the statute, and substitute the judgment of the Commissioner for that of the Board of Directors.

3. The ruling in this case that petitioner's error in following the directions of Internal Revenue officials laid it open to the penalty of this section is in direct conflict with *Cammack v. United States,* 113 Fed. (2d) 507, (C. C. A. 8).

This point is of importance to every taxpayer. Ordinarily, he seeks the advice of the nearest Revenue official. In fact, in a great many cases, officers of the Revenue, deputy collectors, make up the taxpayer's return for him. It is of course true that a failure to charge off a bad debt in a proper year may result in the loss of a credit for it. It is equally true that reasonable judgment and good faith, rather than infallibility, comprise that which is required.

Other circuits so hold.

Avery v. Commissioner, 22 Fed. (2d) 6, (C. C. A. 5).

Rhodes v. Commissioner, 100 Fed. (2d) 906 (C. C. A. 6).

Duffus v. Lucas, 55 Fed. (2d) 786.

Surety Finance Co. v. Commissioner, 77 Fed. (2d) 221 (C. C. A. 9).

Decker v. United States, 71 Fed. (2d) 635 (C. C. A. 7).

Commissioner v. McDonald Engineering Co., 102 F. (2d) 942 (C. C. A. 7).

But, while the taxpayer may suffer for his mistake to the extent of losing his appropriate deduction, this is because it is solely through congressional grace that he is entitled to deduct a bad debt at all. This, however, is an entirely different thing from imposing a penalty on him when, as in the instant case, the omission to charge the debt off in the taxable year was due to the advice of respondent's employes.

The question is not of losing the deduction. The question is of petitioner's bad faith, which should not be predicated upon its reliance on the advice of officials of the Revenue.

Nor is the comment below to us persuasive. Apparently the learned Circuit Judge reasoned that a state of mind, once proved, might be presumed to continue (R. 123). This seems to us fallacious. The fallacy would seem to consist in the assumption, for if the $150,000 debt had been charged off in the taxable year, there could have been no taxable income, and hence there could have been no state of mind concerning it.

Conclusion.

Wherefore, it is respectfully submitted that this petition for a writ of certiorari should be granted.

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